

US OVERVIEW

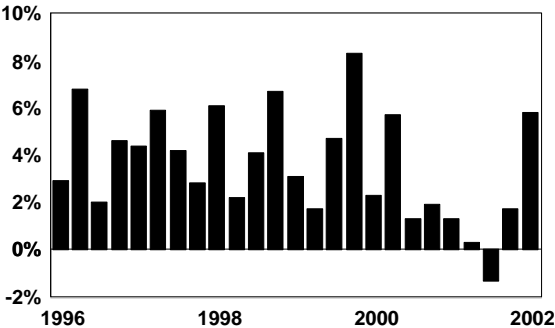
The US economy grew at a rapid 5.8 percent rate in the first quarter. Growth appears to be moderating in the second quarter but should increase in the latter half of 2002. The economy is highly unlikely to enter a “double-dip” recession. The Federal Reserve’s short-term interest rates are at a 40-year low and they will likely remain there until late in the year. Although some are concerned about a real estate bubble, home prices are low relative to stock prices and owners’ equity in real estate is a smaller than usual share of household net worth.

Strong First Quarter

Economic growth can be broken down into increases in employment, increases in the number of hours per employee, and increases in productivity. Payrolls fell about one percent in the first quarter, although this was slightly offset by an increase in the workweek. It was productivity growth that drove first quarter economic growth. Non-farm productivity increased at an 8.6 percent annual rate in the first quarter, the fastest since 1983. Productivity growth tends to increase in the early stages of recoveries as firms stretch to meet rising demand by getting the most out of their workers. Firms that have slashed payrolls and hours are not anxious to hire and lengthen hours until they’re more confident demand will be sustained.

Real GDP

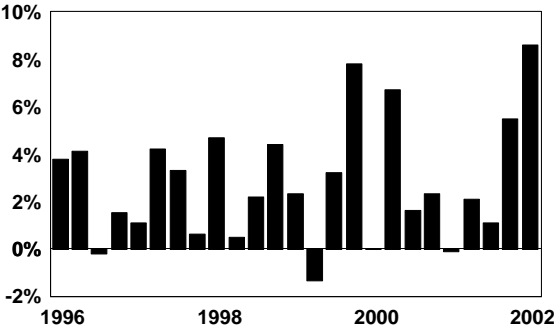
(% change, annual rate)



Source: BEA

Productivity

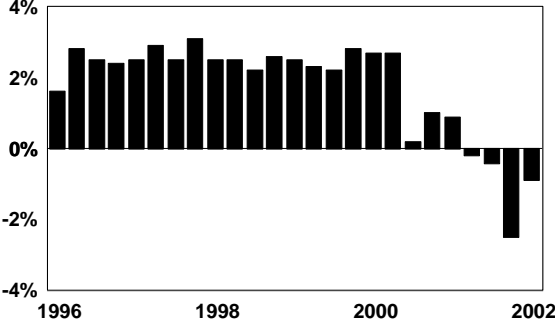
(% change, annual rate)



Source: BLS

Payrolls

(% change, annual rate)

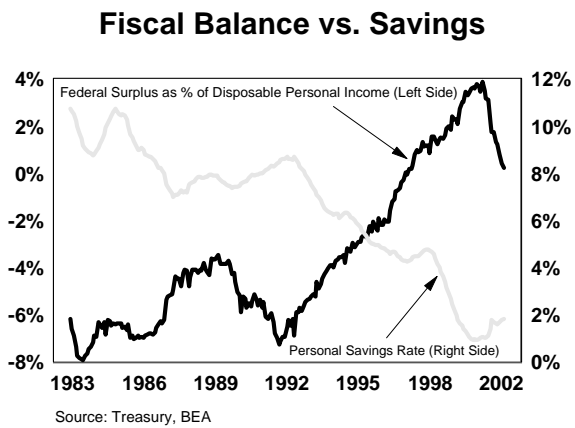
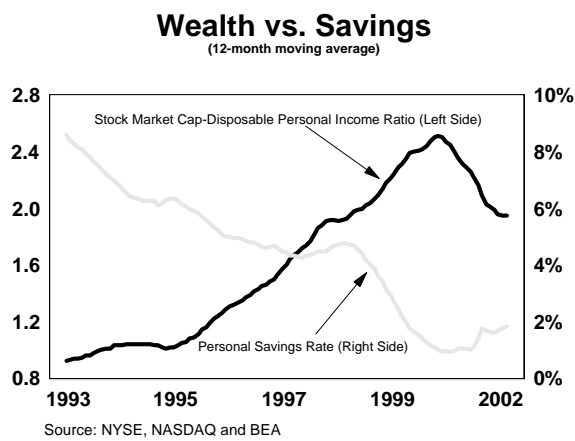


Source: BLS

Second Quarter Slower

Don't get too used to 5.8 percent real GDP growth, though. The economy is almost certainly growing more slowly in the second quarter. Inventories contributed 3.1 points to the 5.8 percent growth rate. For that to happen in the second quarter inventories would have to expand at an annual rate of about \$45 billion, which is unlikely given that we are in the early stage of a recovery when businesses are usually reluctant to increase stockpiles. Also, state and local spending has contributed an average of almost 1 percentage point to real GDP growth in the past two quarters, as opposed to the long-term average of about a third of a percentage point. That trend should stop given the effect of the recession on state and local revenue.

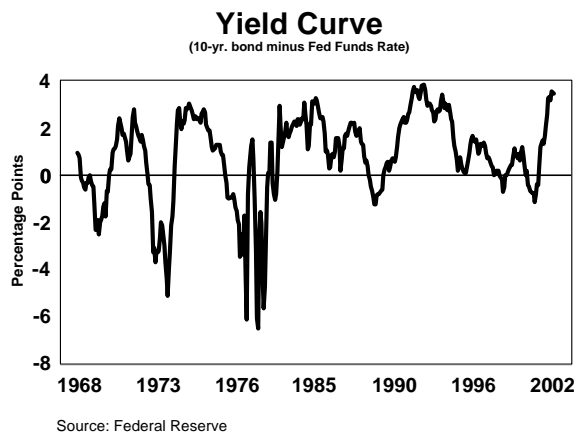
As noted in the January/February *Bulletin*, consumers are not over-extended versus where they were at the end of the 1990-91 recession. However, a couple of factors should restrain personal consumption going forward. Lower equity values are consistent with a rising savings rate. So too is a return to federal deficits.



Certain indicators are signaling slower growth in the second quarter. Continuing claims for unemployment insurance have hit new highs. The Institute for Supply Management's manufacturing composite index and consumer confidence in the present situation both fell in April, the first time that has happened since October.

No Double Dip

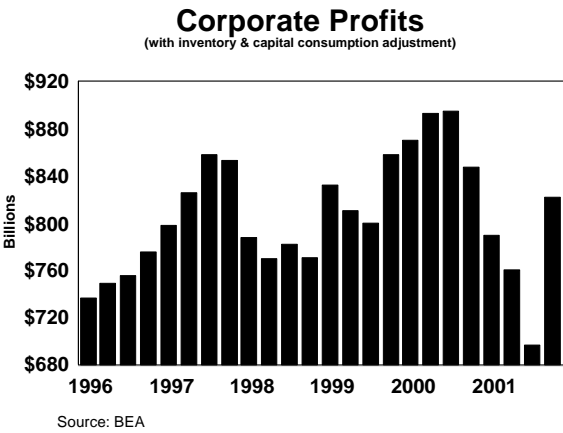
Recent weakening of economic growth has some wary of a double dip recession. These fears are unwarranted. Every recession since 1970 has been preceded by both an increase in short term interest rates and an inversion of the yield curve in which the federal funds rate exceeds the yield on the 10-year Treasury bond by at least one percentage point. In fact, every time both of these developments have occurred a recession has followed – sending no false signals. When one of these signals has occurred without the other no recession has followed. For example, in 1998 the yield curve inverted during the Russia-LTCM financial crisis. However, short-term rates did not rise at all. The inversion was completely due to a drop in long-term rates. And there was no recession, at least not in the United States. Similarly short-term interest



rates rose in 1984 and 1994-95 but the yield curve did not invert and no recession occurred. These signals now suggest the odds of a new recession are extremely low. The Fed has not raised short-term rates in two years and the yield curve is steeper than at any time since 1992-93.

Second Half Solid

Rather than heading into a double dip recession, growth should be strong in the second half of 2002. Business investment has been a drag on growth since early 2001. But corporate profits turned the corner in late 2001 and should lead to a turnaround in capital investment. The profit outlook is changing for a number of reasons. First, the Job Creation and Worker Assistance Act enacted in March boosted tax-related depreciation and the carry-back period for net operating losses. Second, thanks to rapid productivity growth, during the last two quarters unit labor costs have fallen at the fastest rate since 1949. And third, the price of gold has been rising on a year-to-year basis since late 2001. Changes in the price of gold tend to lead changes in corporate profits by six to nine months.

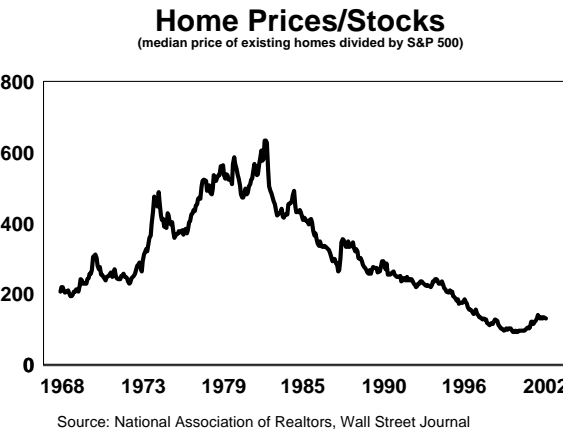


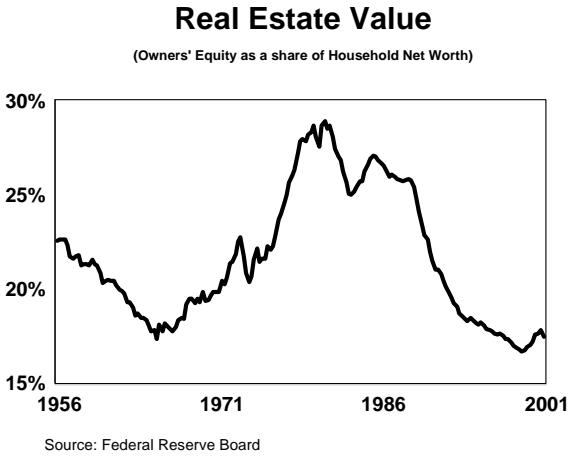
Monetary policy should also boost growth in the second half of the 2002. It takes about twelve months for changes in short-term rates to affect real economic growth. Twelve months ago the federal funds target rate was 4 percent. The Fed was only half done with interest rate cutting. Also, once the Fed starts raising rates economic growth may temporarily increase as borrowers rush to avoid having to pay even higher rates.

Housing Bubble

A source of economic anxiety has been a potential housing market bubble. The economic consequences of a downdraft in real estate prices could be severe. In general, real estate prices are less volatile than stock prices. In turn, homeowners tend to treat changes in the value of housing as more persistent than changes in financial asset values. So, for example, a \$1 loss in real estate should affect consumption more than the same loss in stocks.

Despite the escalation in real estate prices, however, housing still looks cheap. Relative to the S&P 500, the median sales price of existing homes is barely off its early 2000 bottom, as shown in the index chart on the right. The same goes for the average price of new homes. Also, owners' equity in real estate – real estate values minus remaining mortgages – is a relatively low share of household net worth. Arguably, households are still under-invested in real estate versus financial assets. Perhaps households were willing to allow stock market appreciation skew their portfolios toward financial assets as long as stocks appeared to be going up indefinitely. Now that stocks have lost their luster households are finally rebalancing their assets back toward their preferred allocation.





Don’t expect a return of real estate to the relative valuations of the late 1970s and early 1980s. That was driven by expectations of high inflation, which tends to shift investment toward hard assets instead of financial assets. But should the relative value of real estate remain lower than during much of the period before 1971, when the dollar was anchored to gold? Probably not. One way for households to increase owner’s equity is to pay off mortgage debt. An increase in the speed of mortgage retirement would tend to reduce mortgage rates. Another way to increase owners’ equity is to buy more housing. Either way, real estate prices should tend to rise.

Key Economic Indicators

Quarterly Indicators
(Q/Q, at annual rate)

Monthly Indicators

	Q2-01	Q3-01	Q4-01	Q1-02		Feb	Mar	Apr
Real GDP Growth	0.3	-1.3	1.7	5.8	Unemployment	5.5	5.7	6.0
Consumption	2.5	1.0	6.1	3.5	Payroll Growth	-4K	-21K	43K
Business Investment	-14.6	-8.5	-13.8	-5.7	CPI Inflation (yr./yr.)	1.1	1.4	1.6
Trade Deficit (\$ billions)	90.8	78.5	82.9	N/A	Retail Sales Growth (yr./yr.)	3.2	3.8	4.0
PCE Inflation	1.3	-0.2	0.8	0.6	Corporate Rates (Baa)	7.9	8.1	8.0
Productivity Growth	2.1	1.1	5.2	8.6	Federal Funds Rate (Month End)	1.75	1.75	1.75
					Dow (Month End)	10.1K	10.4K	9.9K